DR. KURT RICHEBÄCHER

CURRENCIES AND CREDIT MARKETS

No. 252 / April 1994

"The supply of capital funds will in the long run simply consist of the savings of the community. But over any short period the savings may be supplemented by a release of cash either from existing balances or from bank loans."

R.G. Hawtrey, A Century of Bank Rate, p. 175
Frank Cass & Co. Ltd., 1962.

HIGHLIGHTS

We again reemphasize our warning to investors: Liquidity, liquidity, liquidity! Nothing else matters.

The world's financial markets continue to be shaken in recent days. Is this the beginning of the unwinding of the great, global financial bubble? Although it's inevitable, it's still too early to tell. Nonetheless, the risks clearly remain on the downside.

Very few people grasp just how enormous the present bubble really is. Compared to Japan's boom a few years ago, the present one may appear relatively modest. But in terms of its global reach, this bubble is the most dangerous and pervasive in financial history.

Most financial market pundits still don't realize what's going on and are at a complete loss to explain the carnage. Paradoxically, these blind apologists for the market declines now all call for a return to sanity. The way we see it, a semblance of sanity has returned.

Every crisis is caused by abnormally low interest rates. By stimulating excess spending, illiquidity is always the inevitable result. In that regard, this time was no different. What was unusual is that the spending excesses went largely into the financial markets rather than the real economies.

Why have the European bond markets succumbed to the general downturn in global bonds? Aren't they supported by better fundamentals? While that is true, bond markets all have one thing in common — massive speculation.

The dollar bulls have again been discouraged. Despite the unanimous dollar optimism and DM bearishness, the U.S. currency has sagged. Structural reasons still support our view of an ongoing secular dollar bear market.

There is a powerful elemental force quaking underneath recent market dynamics — a "*dash for cash*." Overall, liquidity is at its lowest in many decades. As the speculative bubble unwinds, the only place for investors is in the safety of liquidity.

For investors, as we have repeatedly emphasized, liquidity remains all important. Short-term bonds in the hard-currency markets and cash-equivalent investment remain the recommended harbours for conservative investors.

NO LONGER TRASH, THE DASH FOR CASH BEGINS

Cracks . . . gaps . . . fissures . . . all continue to spread and shake the world's financial edifice. Yet, the professional pundits are at a loss to explain the cause of the tremors. They grasp at anything to explain the troubles — the Whitewater scandal, the murder of the presidential candidate in Mexico, the open trade squabbles affecting China, Japan and others, the hedge funds — as long as it's unrelated to economic and financial fundamentals and allows them to preach their favourite message: "Perpetual prosperity and continuing bull markets in global stocks and bonds."

In short, tremendous complacency still prevails. There remains an overwhelming belief that the U.S. economy is leading a world economic recovery, though a subdued one, and that the sell-off in financial markets is just a "correction." In our view, the world economic outlook crucially depends on how and when the bubble — the great financial mania that has raged over the past two, three years — finally unwinds. As the bubble deflates, it will have profound depressing effects on economic activity.

As we see it, the prognosis for financial markets remains precarious. At best, we have probably only experienced the beginning of the bust of the great global financial bubble. And bust it ultimately must. Highly leveraged investment positions — particularly in bonds — running into the trillions of dollars still overhang the world's financial system. In short, there's much more pain to come. The irresponsible slogan of the bubble era, "cash is trash," now gives way to a panicked "dash for cash."

THE SMOKING GUN

It's normal to see markets make a partial recovery of their losses following the initial steep downturns. However, since we pointed out the extent of the carnage in the world's stock and bond markets in the last letter, recovery attempts have been extremely feeble . . . in fact, they couldn't have been poorer. Now, as we write, markets are weakening further led by losses in the Anglo-American bond markets.

Global Bond Yields (10-year)

	Recent Low (%)	Mar. 30, 1994 (%)	Change from Low (b.p.)
Germany	5.81	6.51	70
Japan	2.6	4.01	141
Spain	7.75	9.19	144
U.K.	6.1	7.63	153
U.S.	5.16	6.94	178

Global Stock Markets (FTA Indices, Weekly Close)

	Recent High	Mar. 30, 1994	Change From Recent High (%)
France	169.83	154.91	-8.8%
Germany	126.61	120.91	-4.5%
Hong Kong	485.45	389.45	-19.8%
Japan	104.23	100.83	-3.3%
Malaysia	613.75	468.38	-23.7%
Mexico	8822.61	7656.7	-13.2%
U.K.	210.71	190.36	-9.7%
U.S.	194.74	184.35	-5.3%

The neighbouring table provides an updated picture of the extent of the disaster. U.S. long-term interest rates have continued to rise — now as high as 7.16%, 130 basis points higher than the lows of last October — trapping teems of desperate speculators with looming losses. The same applies to the speculators in European and Japanese bond markets who have financed their leveraged purchases with super-cheap short-term rates or through various derivative instruments. You can smell the fear and pain. Yet, the pundits council calm and complacency.

What was it really that suddenly routed stock and bond markets around the globe, hardly sparing any country? And, as well, what explains the other big forecasting flop of the season — a strong dollar as far as the eye could see?

Even the old standby support for the dollar, the "safe haven" argument, has lost its power recently, though there's political strife galore around the globe.

Was it the Fed's "pre-emptive" rate hike aimed against inflation? Though there has been a second hike since the first one on February 4, 1994, the market sages still dismiss the market turmoils as an aberrant move. The common, comforting theme is that all that's needed to reverse the rise in U.S. interest rates is a renewed confidence in the Fed's anti-inflationary vigilance.

It was exactly this that the Fed's first rate hike was supposed to do. Only, it misfired very badly. While the Fed's second tiny rate hike was widely anticipated and taken into stride well in advance, U.S. stocks, bonds, and the dollar are suffering a steady erosion nonetheless.

Could these events foreshadow that much worse is still to come — not only in bonds, but also in stocks and the derivatives markets? The crucial question really is whether or not this sudden, global slump in stock and bond prices could turn into an unstoppable, self-feeding downward spiral. To answer this question properly, a thorough investigation needs to be made of the sources of the vast flows of money that have driven this financial boom. How much of it came from savings; how much from inflation and speculation?

In past letters we have documented and analyzed the rampant bond speculation in the United States. Increasingly, this speculation has spilled over into foreign financial markets last year. Therefore, for some time, we have advocated investments in nothing but short-term bonds . . . even in the hard currency countries. Recently published figures, in fact, make it ever so clear that the speculative mania has infected markets everywhere.

Therefore, for the time being, liquidity should have priority in investment portfolio, whatever the currency. Accordingly, we warned in the last letter: *"Liquidity, liquidity, liquidity. Nothing else matters."* Yet we hasten to add that the magnitude of the speculative excesses and the market fundamentals do differ tremendously between countries. At the very least, that implies differences in future investment risk.

KNOCK-ON EFFECTS

It's been consternating to many market watchers that the slump in U.S. bonds has had such a widespread and immediate domino effect all around the world. (See table on page 2). Most surprising, above all, was the concurrent, sharp rise in European bond yields. Economic conditions on the two continents could hardly be more different. Yet, European bonds have been dragged down in the same undertow.

Now that the U.S. recovery is entering its fourth year with signs of renewed acceleration, a small rise in interest rates makes eminent sense. But the European economies are barely limping along. That, along with the prospect of falling inflation, in the consensus view, should imply that European interest rates, both short and long, should still be declining even if the Federal Reserve does hike its rates. Taking this tack, the recent sharp rise in European bond yields ought to reverse over the course of the remaining year. Or should one expect otherwise?

Again, we dissent. For us, the trashing of Europe's bond markets is not puzzling at all. The connection

between events in different markets may be tenuous, except for one unifying link: frenzied, leveraged speculation.

ON THE TRAIL OF AN INTERNATIONAL SPECULATIVE ORGY

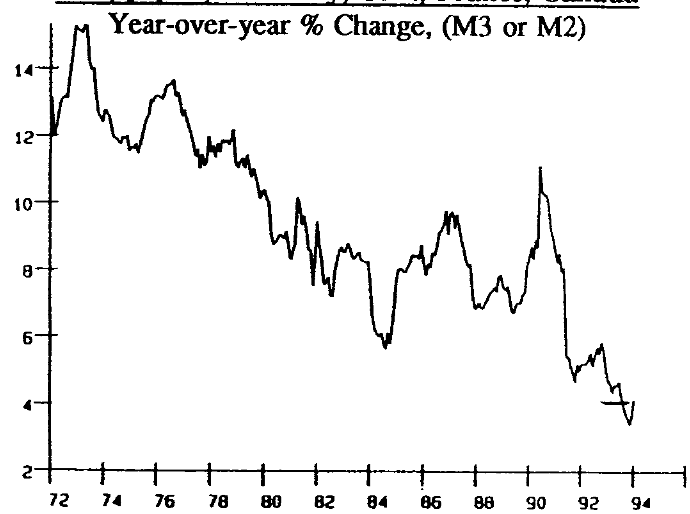
We realize that our view of a bursting global, speculative bubble meets with great hostility among the professionals in the financial markets. First of all, it spoils their windy excuses that none of this was foreseeable. At the same time, it strikes us that there wasn't a single bank or broker — armed with their vast, elite research staffs as they are — that took the slightest bother to seriously investigate the possibility of a bubble. All clung ad nauseam to their worn-out, phoney slogans.

What makes us so brazen to belief that a giant speculative bubble is on the verge of busting contrary to the strong consensus of the majority which has hailed this bull market as the natural result of healthful economic and financial developments?

Firstly, it's a historical fact that financial "bubbles" are never recognized before they burst. Predicting a bubble bust is like forecasting an accident — it's a contradiction in terms. One of the main reasons that's so, is that bubbles generally occur during times of low price inflation. In this respect, Mr. Mieno, the Governor of the Bank of Japan, was the great, great exception. Despite very low inflation rates, he identified the soaring land and stock prices in Japan in the late 1980s as "asset price inflation" and a speculative bubble and prescribed a monetary tightening to bring it to a halt.

Last year, the International Monetary Fund (IMF) published a survey about "asset price inflation" in the 1980s, mentioning Japan, the United Kingdom Australia, New Zealand, the Nordic countries and, on a more limited scale, the United States. The study stressed that these "asset price inflations," in all cases, took place during times when credit and broad money grew well in excess of Gross Domestic Product (GDP). This condition, in fact, supported the stereotypical argument that the respective bull markets in these countries were therefore "liquidity-driven" bull markets. The resulting boom was celebrated as a healthy development, not as an "asset price inflation".

G6 MONEY GROWTH
U.S., Japan, Germany, U.K., France, Canada



Source: International Strategy and Investment

Harking back to the happy memories of the 1980 bull markets, the recent global financial boom has been generally explained as being "liquidity-driven" as well. The snag, though, is that credit and broad money growth is now near its lowest pace of the whole postwar period in many countries. An average of broad money growth for the G6 countries is shown in the above chart. How can there be a boom or even a "bubble" under such tight monetary conditions? While it may seem puzzling, there is an explanation.

BUBBLES FROM THIN AIR

Bubbles need money. Where, then, did the money come from that floated up the global markets so aggressively in recent years? Basically, there were two separate mechanisms that stoked up the asset inflation in the two different parts of the financial market — stocks and bonds.

In the case of the bond markets, overwhelmingly, the torrent of speculative money came from yield-curve playing. Necessarily, this involved massive borrowing. In the case of the stock markets, the money came from a different source: an unprecedented portfolio shift on the financial balance sheet of individual investors as millions of them were lured or chased out of existing cash balances and into securities. Though hundreds of billions of dollars were shifted in this way, it largely didn't reveal itself in the money aggregates.

All this, of course, is well known and widely discussed as we have explained before. But the truly scandalous fact is that these conspicuously abnormal flows are almost unanimously lauded as healthy and beneficial. Whatever drives up securities prices, it appears, is treated as something that is intrinsically healthy. The opinion-makers, of course, have a vested interest.

Admittedly, what has greatly surprised us is how long this yield-curve playing and the associated flight from cash has been taking place. Even more, it has worried us; for we always knew that the longer it lasts, the worse the inevitable crash would be later.

WHERE THE BUBBLE BEGINS

As we have always stressed, the main tap feeding this global financial mania has been operated by the Federal Reserve in the U.S.. It slashed short-term interest rates to a level where they barely covered inflation for a long period of time and supplied over-generous reserve injections in order to keep rates abnormally low.

The biggest bubble of all in terms of the sums involved — although not in terms of capital gains — was in U.S. Treasury bonds. As U.S. stocks and bonds began to look rather expensive last year, the game increasingly shifted to Europe, Japan, and the emerging markets in Latin America and South East Asia. The obvious motive for this offshore buying was a quest for quick capital gains, not the current yields. That, in itself, essentially implies that a massive selling phase would have to follow later.

Fuelled by an apparently inexhaustible flow of money from U.S. pension funds, hedge funds, mutual funds, bank trading and broker desks and many sorts of other highly leveraged speculators, stocks and bonds took off in a near vertical rise around the world in the second half of last year.

Just published figures from various central banks for 1993 shed new light on these cross-border flows between the world's financial markets. We were prepared for staggering figures. But, what we found even exceeded our wildest expectations.

During 1993, net U.S. purchases of foreign stocks and bonds reached $128 billion — by far the largest total in history. This compares to $47.9 billion for the year before. Of the 1993 amount, stocks accounted for $61.1 billion and bonds for an additional $67.2 billion. Yet at the same time, the U.S.

current-account deficit widened sharply from $66.4 billion in 1992 to $103.3 billion in 1993.

Yet, this doesn't give justice to the whole phenomenon. The true total of purchases, we guess, was probably closer to $200 billion, if not higher. That is because the U.S. official statistics fail to catch the large purchases of offshore-domiciled operators, among them most hedge funds. Their transactions are generally channelled through institutions in London.

Partly for that reason, the British capital flow figures are even more breathtaking. According to the statistics of the Bank of England, U.K. net purchases of overseas securities amounted to £121 billion last year or about $180 billion. Genuine U.K. residents, to be sure, accounted for a very small part of this sum, considering that their annual financial savings only total about £30 billion.

The enormity of these sums makes it look as though there were an ocean of liquidity. But is there really? Over the short run, of course, the money has boosted the stock and bond markets. The flip side is that the two main sources of this prodigious flow of money into financial markets — borrowing and a mass exodus from liquid assets into securities — essentially create illiquidity over the longer run. The chart below, clearly shows the extent of the deterioration in liquidity. Household deposits as a percent of income have fallen to new lows.

Every crisis is caused by abnormally low interest rates. By stimulating excess spending, illiquidity is always the inevitable result. Unusual this time is that the spending excesses were largely focused on the financial markets rather than the real economies.

THE RUN UP TO A CHASE FOR LIQUIDITY

We keep wondering about the true objective of the Fed's preemptive rate hike: curbing inflation in the real economy or in the financial markets? At least one Fed governor, Lawrence Lindsey, publicly hinted to the latter:

"Low savings and a shift in household finances to less liquid assets are a threat to continued economic recovery . . . Households are less liquid than at any time in memory . . . I believe that the household sector poses one of the most serious risks to the continuation of this recovery . . ."

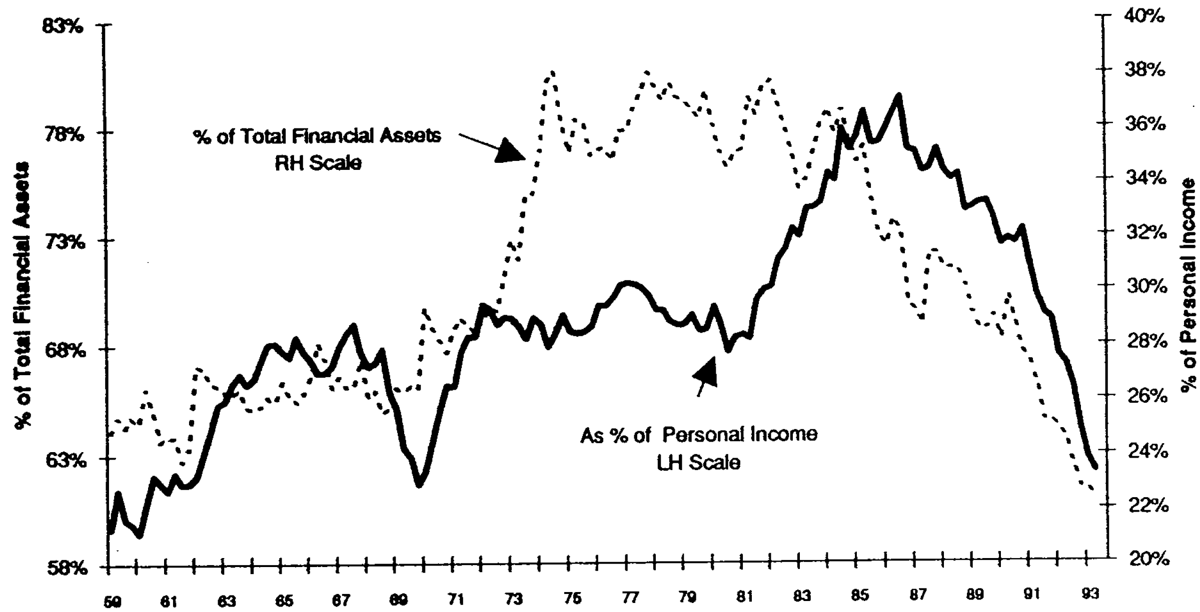
We couldn't agree more. The chart on the next page shows conclusive evidence. But just what is so dangerous about this? It should be obvious to anybody — certainly a central bank — that a mass flight from cash into securities or the leveraged yield-curve play cannot go on forever. To let it get out of hand in the first place, openly courts disaster.

In this light, the Fed has every reason to stop this hazard-causing flight from liquidity by correcting the underlying maladjustment — that is by restoring a reasonable rate of return on cash. Though it may appear paradoxical, what's needed to preserve household liquidity is higher short-term interest rates. Of course, that's not true for the securities markets.

Stalling the liquidity run-off may be — actually, it ought to be — the main motive for the Fed's rate hikes. If so, it would explain the Fed's particularly cautious interest rates hikes, supposedly in hope of gradually deflating the financial bubble without damaging the economic recovery. The hope that this

U.S. HOUSEHOLD LIQUIDITY

Liquid Deposits as a % of Total Financial Assets and Personal Income, Quarterly



Source: Flow of Funds, Federal Reserve Board, U.S. Department of Commerce

can be done successfully is a common delusion of central banks.

ON THE TRAIL OF INTERNATIONAL CAPITAL FLOWS

Very few people, we think, have grasped the enormity of the present bubble. Compared with Japan's boom a few years ago, this one appears relatively modest in terms of bond yields and stock valuations. But in terms of global reach and the sums involved, this bubble is the most unique and pervasive in history.

Just what are the sources of all the money that has propelled stock and bond prices so high and for so long around the world? This is always the cardinal question. If you can identify the source, one can easily distinguish between stable investment and gambling.

Before we begin tracking these sources, we need to point out that one of the greatest propagators of the bubble, the vast trade in derivatives instruments — options and futures mainly — is virtually immeasurable. Though the risks represented by these instruments are enormous, good and complete statistics are simply not available. Suffice it to be said that the principal value of the transactions represented by these instruments are many times the underlying transaction volumes in both stocks and bonds.

Statistically, as we showed earlier, much of the money has come from America and Britain . . . that is from Wall Street and the City of London. But in principle, that's a spurious make-believe story, too, because both nations are deficit countries. The fact that the purchases originate from these countries

doesn't mean that the money came from there. Given their large current-account deficits, how can they export money? The only liquidity they can export is borrowed liquidity. That, in itself, virtually implies a bubble.

To find out further information, we checked the latest figures for portfolio capital flows for the receiving countries. Germany, for one, was at the receiving end of a massive international bond speculation. An examination of its inflows provides a very interesting and clear picture of what makes a speculative bubble.

In 1993, foreign net purchases of German bonds reached the stunning amount of almost DM 229 billion. This inflow alone even overfinanced the huge public sector deficit. What's fascinating as well was the general trend of these purchases. In 1990, when the yields were at their highest, foreign inflows were at their lowest. In 1993, by contrast, an avalanche of foreign money was chasing German yields at levels near the lows of the past three decades. Does this make sense?

Of these foreign bond purchases, almost 60% came via London and another 25% via Luxembourg. London represents international speculators; Luxembourg is the haven of German tax avoiders.

FOREIGN PURCHASES OF GERMAN SECURITIES
In DM Billions

Year	1989	1990	1991	1992	1993
Stocks	22.4	-3.0	3.7	-3.1	14.4
Bonds	22.8	20.3	60.2	133.1	228.6

Source: Bundesbank

A CONTRAST IN LIQUIDITY: GERMANY VS. THE U.S.

Where, then, did the money for the huge foreign purchases of DM bonds come from? Most of it, in short, came from inside Germany. What happened is that German money simply took a round-trip. But, nonetheless, we must distinguish between the players from Luxembourg and London.

To start with, the German tax avoider who wants to escape the newly-introduced withholding tax, exports cash to Luxembourg in order to buy DM bonds from a foreign address. Structuring purchases this way serves to make the income from these bonds tax-free. Conspicuously, cash outflows from German non-banks of about DM 62 billion in 1993 corresponds closely to the DM-bond purchases from Luxembourg.

What about the London-based speculators? The first thing to bear in mind is that they are highly leveraged with borrowed money. But where and in what currency do they borrow? That's a key question. Borrowing dollars and swapping them into D-marks would have been the cheapest way to finance this speculation in DM bonds. But since the world was unanimously bullish on the dollar and utterly bearish on the DM, the bond speculators preferred to borrow in DM.

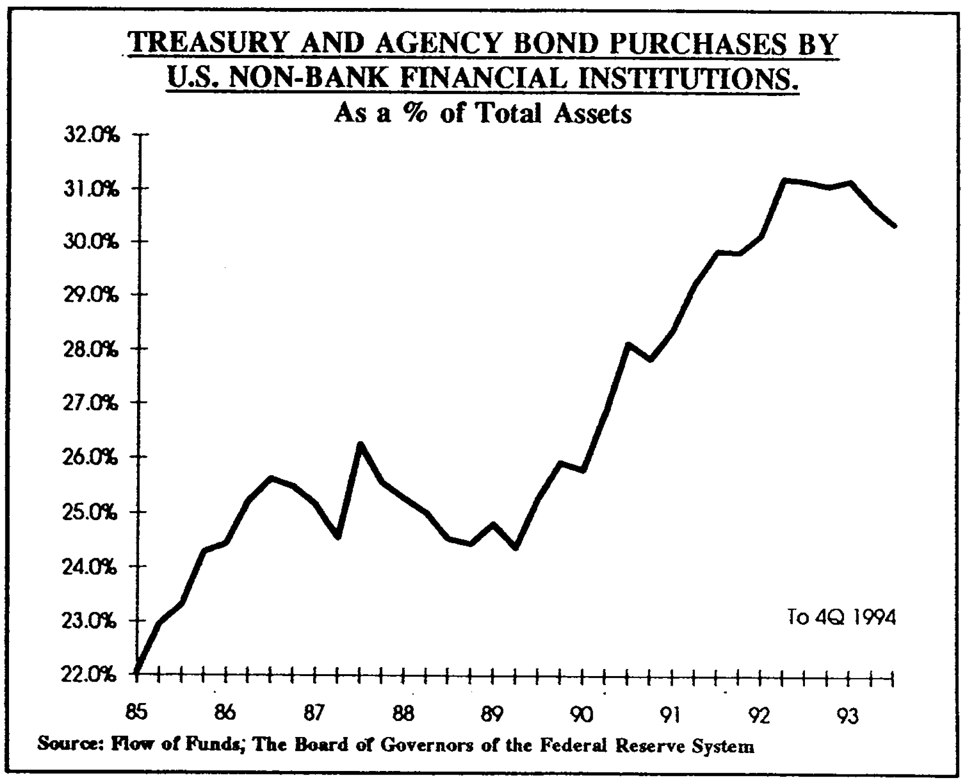
Their main credit source is easy to spot. It's a conspicuous item in the German capital account statistics. What these show is a steep rise of short-term outflows from German banks last year, amounting to more than DM 120 billion. So what we see, believe it or not, is that the speculative orgy in DM bonds was directly and indirectly financed by German banks through the Euro-market.

However, the German case is remarkable for yet another reason. It concerns the behaviour of the German investor which differs diametrically from his foreign counterpart. In reality, the German investor had very little to do with the financial bubble. After Bund yields fell below 7% in late 1992-early and 1993, German investors reduced their heavy buying.

What, then, did the German investors do with their money? Germany's rapidly growing broad money (M3) provides the answer. While Americans, for example, were in a desperate dash from cash and into stocks and bonds, the Germans were increasingly parking their savings in cash — that is, in bank deposits which, in turn, drove the banks into heavy bond buying. The essential result of this circular flow through the German banks is soaring broad money.

The main point that emerges from this is that Germany's strange, strong money growth is the overwhelmingly result of the public's high liquidity preference, not from a credit acceleration. The facts are undeniable. Consider this: over the last two years, total cash balances (M3) rose by about 20% in Germany while in the United States by only 1%.

We have highlighted this tremendous difference in the U.S. and German liquidity trends because it may very well have important implications for their respective markets and the economies. In Germany, domestic investors have high savings and a rapidly growing pool of liquidity at their disposal to help limit the rise in long-term interest rates, not to mention support for a further lowering of short-term rates.



The picture isn't so assuring in some other major countries — the U.S., Britain, Canada, Australia and even Japan. Sizing up the savings and liquidity trends, we wonder how high longer-term interest rates can still rise as the speculative bond mania unwinds. In the case of the U.S., who is left to buy treasury bonds when all the yield-curve players — who virtually printed money — curb their purchases? As we've again showed in the last letter, the bond purchases of U.S. intermediaries have been enormous in recent years. Particularly, the non-banks financial institutions were enormous players in the bubble. The chart above tracks the extraordinary role of this latter group

in the development of the U.S. bond bubble. So, who will be the end buyer when these positions come under liquidation pressures? We have no answer. And nobody else has either.

DIVERGENT INTEREST RATE TRENDS

Looking at the adjustments in the medium- and long-term interest rates, we notice two different movements: firstly, a generally sharp, global, rise in yields; secondly, a decoupling — in other words, a renewed, more pronounced divergence — in longer-term rates.

Since the start of the bond market declines — October 1993 — the best relative performers were the European hard currency bonds. Among the major countries, the U.S., U.K., Spanish and Italian bond markets suffered the biggest losses. During this period, the 10-year yield spread between U.K. gilts and German bunds jumped from a low of 46 basis points to 130 basis points. With a yield jump of 158 basis points, U.S. 10-year Treasury yields (6.74%) have now overtaken corresponding bund yields (6.33%) which only rose 42 basis points.

Most commentators are wringing their hands at the claim that the bond markets have lost all traces of reality. We would say, that at long last, reality is returning. The markets with the biggest losses are naturally the ones where speculation was most rampant. With the silly expectation that international yields have to converge, the global speculator concentrated on the high-yielding bond markets, which in their eyes, seemed to have the most room to fall and therefore promised the biggest capital gains.

In order to reap maximum profits, much of the bond market speculation was also overlaid with a currency play. Given the accentuated bearishness about the DM and the yen, it became a favourite strategy to leverage such bond purchases by borrowing mark or yen. As the bond price would rise and the mark and the yen declined, the speculators figured on reaping a bundle of profits, or so the theory went. Instead, now, both the currency and bond plays have gone awfully wrong.

IN PRAISE OF SPECULATION

According to the textbooks, speculation has a stabilizing influence on markets because the smart speculators spot any aberration and immediately smooth it out by seizing its advantage. That may well have been true when the long-term investor dominated the markets and the speculator was the exception. Today, we have the reverse. Speculation has become a prime business and chief source of profits for numerous financial institutions and corporations. To quote Keynes on this point: "*Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation.*"

What makes it worse than ever, in our opinion, is the lemming syndrome prevailing in the world financial community. There is an unprecedented uniformity in the thinking and predictions of the economists, analysts and the media from Frankfurt to London, from New York to Hong Kong. The financial players have been schooled in the same theories, read the same broker research and newspapers and all converse in the English language. In fact, in our travels, we have always found it remarkable how alike the financial community is in each of the world's financial centres. The result of it is that primitive slogans and crackpot theories can catch on like wildfire. Serious research has mostly gone out the window long ago.

THE DOLLAR DISAPPOINTMENT

Following all the bullish hubris, dollar speculation has again flopped even though the dollar bulls were superficially right in their assumptions. Their bet was that strong U.S. economic growth and a scissor movement of interest rates between the U.S. and Germany — rising in America and falling in Europe — would translate into a robust dollar.

While the expected rate changes are indeed happening, and though the U.S. economy is even stronger than expectations, the dollar has instead weakened. Certainly, we have never wavered in our view that the dollar — and for that matter, the British pound, too — was still in the grips of a long-term secular bear market. Our opinion here has been primarily based on structural reasons: namely, poor savings rates; deficient investment ratios; and the associated large, chronic trade and current-account deficits.

Yet, temporary counter moves to a long-term trend are something that always need to be reckoned with. While the dollar bulls were right on several variables, they were wrong on the key point: To boost the dollar against the DM, more than just a positive economic growth differential between the two countries is required. The decisive element behind the cyclical ups and downs of the dollar are the relative monetary policies of the U.S. That's what primarily determines the money flows. And on that score, monetary policy was, and still is, much too loose in the United States.

Though the Fed has begun to move rates up, the D-mark has continued to gain. We suspect that's because the whole world has been excessively long in the U.S. currency. In other words, these rate hikes have already been amply discounted by the dollar bulls. So now, as rates begin to rise, there are few potential dollar buyers left.

Considerably more Fed tightening may be required to strengthen the dollar. But given the highly vulnerable and hyper-sensitive financial markets, its flexibility is extremely limited. The earlier illusion that rate hikes will tend to stabilize markets by allaying inflation fears has now become a faint memory.

But yet, we still detect a lot of complacency. Many brokers still think that the recent market tremors are nothing more than a blip on the road of a continuing bull market. In response, we can only say that there is a general lack of understanding on the differences between investment and speculation. Our verdict remains the same: There exists a huge financial bubble, one which has only begun to deflate. A careful distinction of the sources of money fuelling the bubble, whether from savings or inflation, proves that our view is the correct one.

Take the yield-curve-play flows of the banks, brokers, hedge funds and hundreds of other institutions into the bond markets. All of these flows are unsustainable involving an annual money creation of hundreds of billions of dollars. Similarly, so is the asset shift out of cash into stocks and bonds. Any beginner student in economics would realize that this can't last. It's precisely these two sources of money that have fuelled the boom . . . the great global financial bubble. All that's needed to smash the bull markets is a marked slowdown in these flows. Anything worse would mean a full-scale crash.

How will the sharp rise in long-term rates and a pronounced slide in stock prices impact the real economies? In short, very negatively, but the effects will certainly differ between countries depending on their respective economic and financial fundamentals.

CONCLUSIONS

Appraising the outlook for the economies and markets, it is imperative to realize just how large and pervasive the global financial bubble really is. The slogan "*cash is trash*" strikingly characterized the recklessness and the stupidity of the opinion-makers in the financial community.

Lately, after long last, the Fed's prolonged, excessive ease and the resulting financial booms has leached into the real economy finally spurring some growth. The key legacy of the prolonged monetary ease, though, is creation of the greatest speculative financial bubble in history, which, when it bursts, will inflict immeasurable damage on the U.S. and world economy.

Acting together, the massive leveraging in the bond markets and the flight from cash into the stock markets has created the illusion of a liquidity glut. The reality — at least for the major countries — is that there's actually been a dramatic deterioration of liquidity. Given the extent of the bubble, the risk is clearly on the side of a self-feeding meltdown.

The outlook for the economies now rides on the unwinding of the great financial bubble. Once it begins in earnest, it will severely depress some of them.

Risks in global financial markets remain treacherously high, particularly for stock markets. The hard-currency bond markets, though, retain the most supportive fundamentals.

Capital preservation remains the overriding objective. Investors should continue to focus on short-term, cash-equivalent securities.

Next Issue to be Mailed on May 4, 1994.

Publisher and Editor, *Currencies and Credit Markets*: Dr. Kurt Richebächer, GERMANY
TELEPHONE 49-69-746908 FAX: 49-69-752583
Associate Editor: Wilfred J. Hahn, CANADA

Subscription and Administration Inquiries and Service: Mulberry Press Inc. 7889 Sixteen Rd., Caistor Centre, Ontario, CANADA, L0R 1E0. TELEPHONE: (905) 957-0602 FAX: (905) 957-0602.

Annual Subscription Rates: 12 Issues. North America: $US 400.00. Subscribers outside of North America: DM 600.00